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Washington Brown
QUANTITY SURVEYORS

# THE PROPERTY INVESTOR'S GUIDE TO DEPRECIATION

## HOW TO SAVE MONEY ON TAX

TYRON HYDE

TAX SAVINGS 100% GUARANTEED

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# WHAT IS DEPRECIATION?

If you're reading this ebook, I think it's safe to assume that you are a property investor. If not, you are seriously considering becoming one. Perhaps you are trying to work out whether a property is a good investment or not, and some-one has suggested you check out the cash flow 'after depreciation'? Or maybe you've been looking at a newly-built property and the salesperson has been advising you of the depreciation allowances.

The world of property investing can be daunting when you start out and it is important to educate yourself about all aspects of investing. So congratulations on seeking out some information about depreciation.

Let's start right at the beginning. What is depreciation? Depreciation is basically a tax deduction available to property investors.

This is how it works.

Your investment property earns an income (in the form of rent from your tenants). So, as with any activity that produces an income, there are various tax deductions available to you. Normally these tax deductions are things you've spent money on, such as property management fees, council rates and other miscellaneous items. You pay an amount of money, you receive a tax invoice and receipt, and

**Depreciation is basically a tax deduction available to property investors.**

you use that piece of paper to claim a tax deduction when tax time comes around.

## NON-CASH DEDUCTIONS

However, property depreciation is what the tax office calls a 'non-cash deduction' – which means you don't physically fork out cash in order to claim a deduction. It is also referred to as an 'on-paper deduction' for the same reason.

Depreciation allows you to claim a tax deduction for the wear and tear on an investment property over time. This tax deduction recognises the fact that the building itself, as well as its plant and equipment (air-conditioners, blinds, carpet, etc.) will become worn out over time and eventually need to be replaced. It doesn't matter that these items were paid for by someone else – a developer or previous owner – you, the current owner, can continue to claim deductions as they continue to depreciate in value.

## MORE MONEY IN YOUR POCKET

As with any tax deduction, depreciation basically reduces your taxable income. So if your income was $100,000 for the year, and you claim $10,000 worth of deductions, you only pay tax on $90,000.

The table on the next page shows you the difference depreciation can make to monthly returns from your property investment.

Of course, these calculations are for the purposes of illustration only, the exact amounts depend on the age of your property and various other variables.

## No depreciation claimed compared with depreciation claimed

| One-bedroom city apartment | Without depreciation | With depreciation |
|---|---|---|
| Purchase price | $500,000 | $500,000 |
| Rental income (p.a.) | $28,600 | $28,600 |
| Less mortgage (p.a. @ 5%) | $27,000 | $27,000 |
| Less property expenses (p.a. @1.5%) | $7,500 | $7,500 |
| Less depreciation 1st year | – | $14,000 |
| Tax loss/your tax deduction | -$5,900 | -$19,900 |
| Annual refund based on 37% tax rate | $2,183 | $7,363 |
| **Monthly refund if applying for PAYG variation** | **$181** | **$613** |

# HOW IS DEPRECIATION CALCULATED?

Before getting scared off by the following explanation, you need to know that a quantity surveyor can inspect your property and prepare a depreciation schedule for you. All you'll need to do is hand it over to your accountant at tax time. And that's all you need to know, if you wish. If you do your own tax return, you can easily include the figures from the quantity surveyor's report yourself.

You don't need to worry about complicated calculations. In practice, it's as easy as a phone call to a quantity surveyor to ensure you get all of your allowable depreciation deductions. (The **Washington Brown** national number is 1300 990 612.)

Many investors, however, will want to understand the process for themselves. So, now for the nitty gritty.

## TWO PARTS TO DEPRECIATION

To give you some background, there are two parts of the *Income Tax Assessment Act 1997* that deal with depreciation:

1. Division 43 (Capital Works Allowance); and
2. Division 40 (Plant and Equipment).

**It's as easy as a phone call to a quantity surveyor to ensure you get all of your allowable depreciation deductions.**

**The capital works allowance** (more commonly referred to as the building allowance) refers to the construction costs of the building itself, such as concrete and brickwork, plus capital cost items, which include swimming pools, spas, automatic doors and many other items your quantity surveyor will know about.

**Plant and equipment** refers to items within the building like ovens, dishwashers, carpet and blinds, etc. The list is much longer and can be found at: ATO List of Depreciable Assets.

The building allowance is calculated at between 2.5% and 4% per year of original construction costs (depending on the date of construction). Plant and equipment has a number of categories in which items are claimed at different percentages over their effective life. Your quantity surveyor will know these too and calculate them in your depreciation report.

## USING DEPRECIATION CALCULATORS

You can use the **Washington Brown depreciation calculator** to work out how much you can claim on any property you are thinking of investing in. You can also download the iPhone app or Android app.

I've taken the example of a standard $400,000, high-rise, two-bedroom unit in Melbourne in the example on the next page.

## Example of Depreciation Calculator

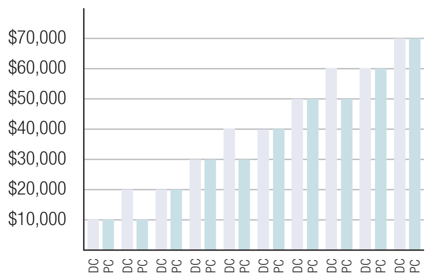
| Please answer the following questions: | |
|---|---|
| What is the purchase price of the property? | $400,000 |
| The nearest city to the investment property is? | Melbourne |
| What is the standard of finish? | Medium |
| What type of property is it? | High-rise |
| In which year was your property built? | 2008 |

Please note the calculations produced below are estimates only and not to be used for taxation purposes

Get a Quote | Calculate

| Years | Diminishing value | Prime costs |
|---|---|---|
| Year 1 | $11,000.00 | $7,000.00 |
| Year 2 | $8,000.00 | $7,000.00 |
| Year 3 | $8,000.00 | $7,000.00 |
| Year 4 | $7,000.00 | $7,000.00 |
| Year 5 | $6,000.00 | $7,000.00 |
| Year 6 | $6,000.00 | $7,000.00 |
| Year 7 | $6,000.00 | $7,000.00 |
| Year 8 | $6,000.00 | $7,000.00 |
| Year 9 | $6,000.00 | $7,000.00 |
| Year 10 | $5,000.00 | $7,000.00 |

**Chart – Diminishing value vs prime cost**



# WHO ISSUES DEPRECIATION REPORTS?

Having been in this industry for more than two decades now, I've met all sorts of property developers and investors. Many of the calls and inquiries I receive are from frustrated investors who could not get depreciation reports (or schedules) from their accountants or real estate agents. And there is a reason for that.

If your residential property was built after 1985 your accountant is not allowed to estimate the construction costs. Tax Ruling 97/25 has identified quantity surveyors as properly qualified to make the appropriate estimate of the construction costs, where those costs are unknown.

Based on this ruling, accountants can offer advice around other aspects of tax depreciation, but construction costs and property depreciation are highly technical domains and must be calculated or estimated by qualified quantity surveyors.

**At last count, my company Washington Brown has assessed over 160,000 properties for tax depreciation. We now complete approximately 200 depreciation reports per week, that's over 10,000 per year!**

# TAX DEPRECIATION: MYTHS & TRUTHS

I'm often amused by some of the things I hear about depreciation. Over the years, I have heard some incredible statements. So here I'll give you the facts and dispel any of the myths that you might encounter.

### 1. MYTH: You can only depreciate new properties

There is a myth that you can only claim depreciation on new properties. This is not true. The truth is, old properties depreciate too because the purchase price of your property includes the land, building, and plant and equipment. This means even properties built before 1985 (when the building allowance kicks in) are worth depreciating. Whatever the age of your property investment you should have a quantity surveyor have a look at it and provide you with a report.

### 2. TRUTH: The taller the building, the higher the depreciation

Sounds a bit odd, but this is true. Taller buildings attract higher plant and equipment allowances and therefore higher depreciation claims. Some of the services required as buildings increase in height are obvious, such as lifts (and other transport services). Other services are less obvious, such as fire hose reels and intercoms which are all depreciable under this category. The other reason tall buildings attract higher depreciation is because of the higher ratio of plant and equipment due to the amenities the developer provides. For instance, some high-rise buildings have swimming pools, gyms and even mini cinemas.

### 3. MYTH: All construction costs are eligible for depreciation

In this country we are fortunate we can claim the depreciation of an investment property as a tax deduction. But not all construction costs are eligible.

When claiming depreciation of a building we are essentially claiming what is there now. So it stands to reason that costs such as demolition or site-clearing can't be claimed. Landscaping is another construction cost that you have to be careful with. Trees and grass grow, so they don't depreciate over time!

### 4. TRUTH: Building profit can be claimed

If you engage a builder directly to complete your investment property, then you can claim the builder's profit component of the work. However, if you buy a finished apartment from a speculative builder/developer, then their building/developing profit does not form part of the amount you can claim.

### 5. MYTH: A depreciation report is not worthwhile for a property bought close to the end of the financial year

In the first financial year of ownership – even if you take ownership towards the end of the financial year – it is not uncommon for an investor to claim thousands of dollars' worth of deductions for a property purchased close to June 30. Why? Well, specific plant items in the property valued under $300 are eligible for an immediate write-off and those under $1,000 can be 'low-pooled' and written off at an accelerated rate of 18.75%. As neither of these amounts should be pro-rated, they can be claimed in full regardless of whether the property has been owned for 1 day or 365 days.

### 6. TRUTH: Furnishing can boost your depreciation claims

Furnishing your property is another way to increase your depreciation deductions as it attracts higher depreciation rates. For example, a $20,000 furniture package supplied by a developer can result in an additional $10,000 deduction in the first year alone. But remember, furnishing your investment isn't necessarily the best option for all properties and locations. It's better suited to smaller one or two bedroom apartments in transient areas that attract short-term tenants and holiday rentals. Other property types might be more difficult to let if they are furnished.

### 7. MYTH: Accountants can prepare depreciation schedules

The truth is an accountant, real estate agent or property valuer is not qualified to prepare a depreciation schedule on your property. The ATO has identified quantity surveyors as appropriately qualified to estimate the original construction costs in cases where that figure is unknown.

# YOUR DEPRECIATION REPORT

First of all, let me say this, not all depreciation reports are created equal. The old adage “you get what you pay for” is very relevant when ordering a depreciation report (or schedule). I’m going to give you some top tips every property investor should know when ordering a depreciation report.

## DON’T DIY DEPRECIATION

As an expert in the market I am baffled by the number of companies offering do-it-yourself depreciation schedules.

Not only are there some potential legal issues with this but, more importantly, you will be missing out on deductions. The DIY option generally gives you a tick sheet and asks you to take your own measurements of rooms and other parts of the property.

Now, let’s say you measure from one bedroom wall to the other. If you do that all around the house you could reduce the property by 10% in gross area. At around $1,500 per square metre to build, you would have missed out on something like $15,000 worth of tax deductions.

When a client comes to us needing a depreciation report, we will send out a quantity surveyor to do a thorough site inspection. This involves measurement of all the rooms and areas in the property (allowing for wall widths and other anomalies) and all the plant and equipment items including carpets, blinds, ovens and air-conditioners. It is a thorough process and you should use technically qualified people to do it.

The Australian Institute of Quantity Surveyors' (AIQS) Code of Practice also stipulates that site inspections are necessary to satisfy ATO requirements. This guarantees you won't miss out on any deductions. The documentation can then be used as evidence in the event of an audit. The AIQS also points out that those property owners who attempt to estimate their own depreciation, or use non quantity surveying qualified people, risk submitting an incomplete or poor depreciation report, which could be a double whammy. It could not only cost them in missed deductions but could also possibly attract an audit by the ATO if their report is not up to the standard required.

## USE A REGISTERED TAX AGENT

Since March 2010, anyone who produces a property depreciation report must also be a registered tax agent. This is a good thing for property investors. I have been preparing depreciation schedules for more than 20 years now and have never seen so many "experts" entering the market over the last few years.

To be sure, ask your depreciation report supplier if they are a registered tax agent. You can also visit the Australian government's Tax Practitioners Board website **www.tpb.gov.au** to check their credentials.

**Remember, if your residential property was built after 1985, your accountant is not allowed to estimate the construction costs. Neither is a real estate agent, property manager nor a property valuer. You need a quantity surveyor to estimate the costs.**

**Preparing a depreciation report is a thorough process...**

## PRO-RATA YOUR DEPRECIATION REPORT

Everyone exchanges and settles a property on different days. However, the end of the financial year only occurs once. Your report should calculate exactly how much you can claim for building allowance depreciation, based upon the number of days you have owned the property in that financial year. For instance, if you settled on June 30, you should only be claiming 1/365 of any value attached to, say, the oven or the carpet (see the section below on small items and low-value pooling for exceptions to this rule). Some reports don't do this calculation for you. This will cost you money in terms of accounting fees.

One thing I'd like to point out on the timing of your depreciation report is that you should get it sooner rather than later. Don't wait for the end of financial year deadline when everyone is scrambling to get a report. If you have settled on a property late in the year (say around November or December), order a depreciation report right away so you can avoid the June rush. In some circumstances, you are also able to request monthly deductions, rather than wait until the end of the financial year, and having the depreciation numbers included in your tax variation will assist you.

## SMALL ITEMS AND LOW-VALUE POOLING

Having said that depreciation deductions are pro-rated depending on when you take ownership of a property, I'll now give you an example that proves an exception to the rule.

A Sydney client of ours settled on a one-bedroom Chatswood unit on June 25th last year. The property was built in 1999 and the purchase price was $450,000. Yet, their total tax deduction, which was for five days only remember, was more than $5,000.

"What's the catch?" I hear you ask. Well, there isn't one. The ability to make such a significant deduction for just a short period of time is due to the immediate write-off and low-pooling of items that are classified as plant and equipment.

The costs of 'small items' (valued at $300 or below) and 'low-pooled items' (totalling no more than $1,000) should not be pro-rated, they can be written off immediately. You can maximise these items whether the property has been owned for 1 day or 365 days. And the age of the property is not relevant to claiming small items or low-value pooled items. Plant and equipment in properties of any age are eligible for depreciation allowances.

There is a saying that goes, "a dollar today is worth more than a dollar tomorrow", so deduct these items as quickly as possible.

But what if you are a joint owner? For example, say an electric motor to the garage door cost the owners of an apartment block $2,000. If there are 50 units in the block, your portion is $40. You can claim that $40 outright as your portion is under $300. Provided your portion is under $300 you can still write it off.

Another tip is to buy items that depreciate faster. Items costing between $300 and $1,000 fall into the low-pool category and attract a higher depreciation rate. A $1,200 television attracts a 20% deduction while a $950 TV deducts at 37.5% per annum.

## SIZE DOES MATTER!

Big doesn't always mean best. But when it comes to depreciation reports make sure you get some bang for your buck!

Some depreciation reports only provide you with one year of depreciation allowances. That means, from the second year onwards you need to work out how much you can claim.

Make sure your report lasts at least 20 years, and if it's a brand new property the report should last for 40 years.

## HAVE YOU LIVED IN THE PROPERTY?

If you bought a property and lived in it for a while before renting it out your depreciation schedule should reflect that. The report should show that the property was owner-occupied for the first period then show the amount you can claim once the property becomes an income-producing asset.

This may sound simple, but not all reports calculate this for you. Again, this will save you money in reduced accounting fees and could save you from a tax audit.

## CAN REPORTS BE SPLIT?

If you have purchased a property with a friend or family member, your depreciation schedule should be separated into individual reports that reflect how much you each own of that property.

This will not only save you money in terms of accounting fees – but can save your hard-earned dollars as the table on the next page shows.

Because the television costs over $300 it can't be written off immediately. By splitting the report, the television price now reflects the investors' individual ownership. This enables each investor to claim the television as an immediate deduction.

### Comparison of combined and separate reports

| | Item | Purchase price | Tax rate | Tax deduction |
|---|---|---|---|---|
| **Combined Report** | | | | |
| John & Mary Smith | Television | $305.00 | 18.75% | $57.19 |
| | | | **Total** | **$57.19** |
| **Separate Reports** | | | | |
| John Smith (50%) | Television | $152.50 | 100% | $152.50 |
| Mary Smith (50%) | Television | $152.50 | 100% | $152.50 |
| | | | **Total** | **$305.00** |
| Net result a 500% increase in deduction in 1 year | | | | |

## HAVE YOU IMPROVED THE PROPERTY?

If you have renovated or updated the property, make sure your report reflects this. Provide your quantity surveyor with a list of purchased items, their price and a date of installation. The more accurate this list, the higher your deductions are likely to be.

## FIGURES AT YOUR FINGERTIPS

The best depreciation reports have the ability to be downloaded to an Excel spreadsheet or even to be imported into accounting software packages.

This means when you receive your depreciation report you can extract the numbers into your own spreadsheets or, better still, your accountant can load them straight into their software package.

This will save your accountant time (as they won't be required to enter the data manually) which you would expect would save YOU money in accounting fees.

# WHAT IF MY SMSF OWNS THE PROPERTY?

Your depreciation report will vary, depending on the entity that owns the investment property.

The self-managed superannuation fund (SMSF) sector in Australia has seen tremendous growth over the past few years. This is not a surprise, given the rising trend for investors to take control of their money. And fair enough, if you think you can manage your money better than anyone you may be more comfortable, and will enjoy more peace of mind, looking after it yourself.

Trustees of SMSFs will be aware of the changes in SMSF rules and guidelines on borrowing to invest. This has allowed more SMSFs to explore investing in property through their fund.

Each individual investor must look at their own set of circumstances before deciding in what name to purchase a property. Taxation is one consideration and depreciation allowances are one part of the taxation puzzle. Personally, I have purchased property in my own name, my super fund and in a trust – all for varying reasons.

I always seek financial advice from my accountant or financial adviser before entering a contract and you should too. That way I know the entity that ends up holding the asset is the right one from the beginning. Changing the structure of your investments can be a difficult and costly exercise.

# WHAT IF MY PROPERTY IS OVERSEAS?

More and more Australians are investing in property overseas due to the Australian dollar being high and some countries' economies being much weaker than Australia's and showing a down turn in their property markets. But can you still claim depreciation if your investment property is not in Australia?

The answer is yes, you can depreciate an overseas investment property... but there are a few key differences.

The first main difference is in regards to claiming the building allowance. With Australian properties you're entitled to claim 2.5% of these construction costs per annum, as long as the property was built after July 1985. The rate for overseas properties is the same – but the date is different. Construction of an overseas property must have commenced after 1992.

So if you want to maximise your deprecation benefits on an overseas property, look for a newer property built in the last decade or two.

Internal items of plant and equipment, such as carpets, ovens, lights and blinds, can also be depreciated as they would be in an Australian investment property. There is a very useful publication you can download from the Australian tax office website, "Tax Smart Investing: What Australians Investing in Overseas property need to know".

**Construction of an overseas property must have commenced after 1992.**

The main barrier to depreciating an overseas property is working out the construction costs, along with the expense of flying a quantity surveyor overseas to prepare your depreciation report.

**Washington Brown** has a number of affiliations around the world and we regularly inspect properties in London and New Zealand. I even did an inspection in Koh Samui, Thailand.

# USE AN EXPERIENCED QUANTITY SURVEYOR

If you have just paid hundreds of thousands of dollars for a property, do you really want to save a couple of hundred tax-deductible dollars on the only tax break available to you that can be open to interpretation and skill?

The laws have changed frequently over the years and each building is unique, so it pays to get expert advice.

I suggest you engage a firm that has been around for at least 10 years. They will have the necessary experience to analyse your property correctly. Don't fall into the trap of assuming that anyone involved in the project can accurately estimate the construction costs.

At **Washington Brown**, we are experts at estimating construction costs. That's what we do on a daily basis, whether it is for a property developer, a property financier or a builder.

# CONTACT US

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